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FISCAL POLICY AND THE TRADE DEFICIT

Summary

Congress has focused its attention on sectoral trade issues with Japan instead of concentrating on the underlying macroeconomic trends that influence trade. Divergent fiscal policies pursued in Washington and Tokyo have led to current account imbalances in both countries. Japan's declining government budget deficit has increased the level of private savings available for overseas investment. The increased Japanese capital outflow is, of course, matched by a higher current account surplus. The United States, with its large government deficit, has become a major capital importer and reports a large current account deficit.

Many of the solutions offered to narrow the U.S. trade deficit with Japan, such as protectionism and capital controls, would be counterproductive or ineffective. Instead, the United States should reduce its budget deficit and Japan should increase domestic investment through supply-side measures. Even if both countries eliminate their current account imbalances, however, the United States is still likely to run a trade deficit with Japan on the order of $15 to $20 billion a year because of the structures of the two economies.

The Current Situation

The U.S.-Japan economic relationship has been marked by friction over trade in such goods as cars, semiconductors and telecommunications equipment.

Congressional resentment toward Japan led to the resolution passed unanimously in March urging the president to retaliate against Japan. The macroeconomic issues underlying these sectoral disputes, however, have received less attention on the Hill.

In 1981, when the United States last reported a current account surplus, the U.S. trade deficit with Japan was $15.8 billion. In 1984, the United States had a huge current account deficit of $101.5 billion and the bilateral trade imbalance reached $33.6 billion. This $17.8 billion increase in the U.S. trade deficit with Japan has led to pressures for a protectionist response.

Even Japan's most vociferous critics do not claim that import restrictions were responsible for the increase in the U.S. trade deficit. The seven market opening measures announced by Tokyo during the past four years have lowered these barriers significantly. U.S. exports to Japan rose 8 percent from 1981 to 1984, in contrast to a decline in American shipments to the European Community during the same period.

The increase in the U.S. trade deficit with Japan is actually a result of the economic policies pursued by Washington and Tokyo. During the past five years, the two governments have followed divergent fiscal paths. Although the trade impact of fiscal policy was unintended, it has had a significant effect on the bilateral trade balance. While Japan has been steadily reducing its government budget deficit, the United States has run large deficits in the range of $200 billion annually.

A nation's current account balance (goods and services plus unilateral transfers) is determined by the difference between domestic savings and investment. When domestic investment and the government budget deficit do not absorb private savings, the remainder is invested overseas. That overseas investment must be matched by a corresponding current account surplus. A current account deficit occurs when domestic investment and the government deficit exceed private savings. The shortage of domestic savings is offset by an inflow of capital from abroad that matches the current account deficit. The relationship between the domestic savings and investment balance can be shown using national accounting identities (see Appendix).

Trends in the United States

Table 1 shows the trend in U.S. savings and investment during the past ten years. Between 1975 and 1982, the balance between savings and investment, shown in row 5, averaged about zero. The average current account (which, except for statistical discrepancy, equals the savings-investment balance) was also zero. During the past two years, however, the savings shortfall jumped to 2.4 percent of GNP, resulting in the $101.5 billion current account deficit of 1984.

Two possible explanations of the savings-investment shortfall during the past two years are a decline in private savings and an increase in private investment. During the past decade, gross private savings fluctuated between 16.5 percent and 18.4 percent of GNP. Personal savings accounted for about

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Table 1: U.S. Savings, Investment and Current Account

(percent of GNP)

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
1. Gross Private Savings	16.0%	18.2%	17.1%	17.0%	17.3%	16.8%	16.5%	17.2%	17.1%	17.3%	18.4%
a. Personal Savings	5.6	6.1	4.8	4.1	4.1	4.0	4.2	4.6	4.4	3.6	4.3
b. Business Savings	10.4	12.2	12.3	13.0	13.2	12.8	12.4	12.6	12.6	13.7	14.2
2. Private Investment	14.5	13.3	15.0	16.9	17.9	17.5	15.3	16.4	13.5	14.3	17.4
3. Private Balance (1-2)	1.5	4.9	2.1	0.1	-0.6	-0.6	1.3	0.9	3.6	3.0	1.0
4. Government Balance	-1.1	-4.1	-2.1	-0.9	0.0	0.6	-1.2	-0.9	-3.8	-4.1	-3.4
a. Federal	-1.2	-4.5	-3.1	-2.4	-1.4	-0.7	-2.3	-2.2	-4.8	-5.4	-4.8
b. State and Local	0.2	0.4	1.0	1.5	1.4	1.3	1.2	1.3	1.1	1.3	1.4
5. Total Balance (3+4)	0.4	0.8	0.0	-0.8	-0.5	-0.1	0.1	0.0	-0.2	-1.0	-2.4
6. Current Account	0.2	1.2	0.2	-0.8	-0.7	0.0	0.1	0.2	-0.3	-1.3	-2.8

Source: Council of Economic Advisers, Economic Report of the President, 1985

one-fifth to one-third of the total, while business savings accounted for the remainder. Although low relative to other countries, savings as a share of GNP in 1984 were at the highest level in 40 years and exceeded private investment.

Many economists emphasize the role of the Economic Recovery Tax Act of 1981, which lowered the rate of taxation on income from new investments, in encouraging investment. The level of private investment in 1984, however, was not exceptionally high; in fact, its share of GNP was less than in 1978 and 1979. Moreover, the pool of savings was more than sufficient to finance the increased investment.

Neither of these factors, therefore, appears to explain the savings-investment imbalance and large current account deficit. It is the size of the government deficit, instead, that is primarily responsible for the imbalance. The huge government deficits during the last two years of vigorous economic growth were matched only during the recession years of 1975 and 1982. From 0.9 percent in 1981, the government deficit increased to 3.4 percent of GNP last year, overwhelming surplus private savings and pushing the savings-investment balance into the red. The federal government is entirely responsible for the increased deficits, since state and local government surpluses as a share of GNP were actually higher in 1984 than in 1981.

It is interesting to compare the recession years of 1975 and 1982. Federal government deficits in both years were large -- 4.5 and 4.8 percent of GNP, and private investment was depressed at about 13 percent-plus of GNP. Following the 1975 recession, the federal deficit's share of GNP was reduced to 2.4 percent in two years. Two years after the 1982 recession, however, the federal budget shortfall remained at a high 4.8 percent of GNP, despite the 6.8 rate of real economic growth in 1984. If the same degree of fiscal restraint on both spending and taxing that prevailed after the 1975 recession had been applied following the 1982 recession, the large savings-investment imbalance and accompanying current account deficit could probably have been avoided.

Trends in Japan

In addition to Japan's very high level of private savings, the total government budget, including social security and local governments, was in surplus prior to the first oil shock. The large pool of savings was absorbed by an equally high rate of private investment in the early 1970s. Following the 1973-74 oil crisis, however, investment fell substantially, averaging about 22 percent of GNP during the second half of the 1970s (see Table 2). This reduction in investment was offset by growing deficits in the government balance, which first fell into the red in FY 1975.

Japan's current account balance swung from a $13.9 billion deficit in FY 1979, the year of the second oil shock, to a $24.2 billion surplus in FY 1983. Two factors explain the changes in the current account and in the savings-investment balance, which increased from minus 1.5 percent to 2.3 percent of GNP: domestic private investment's share of GNP declined by 3 percentage points and the government imbalance as a share of GNP improved by 1.4 percentage points as a result of reduced central and local government budget deficits. The fiscal restraint exercised by Tokyo was in sharp contrast with

Table 2: Japan's Savings, Investment and Current Account

(percent of GNP)

	FY 1970	FY 1975	FY 1976	FY 1977	FY 1978	FY 1979	FY 1980	FY 1981	FY 1982	FY 1983
1. Gross Private Savings	30.6%	26.2%	26.9%	26.7%	26.3%	26.0%	26.4%	26.1%	25.0%	25.5%
a. Household Savings	12.0	16.7	15.9	15.6	14.3	13.7	13.9	14.1	12.5	12.7
b. Business Savings	18.6	9.5	11.0	11.1	12.0	12.3	12.5	12.0	12.5	12.8
2. Private Investment	30.7	23.4	22.9	21.4	21.4	23.1	22.9	21.9	21.1	20.1
3. Private Balance (1-2)	0.0	2.8	4.0	5.3	4.9	2.9	3.4	4.1	3.9	5.3
4. Government Balance	1.9	-3.6	-3.5	-4.1	-4.1	-4.4	-4.0	-3.7	-3.5	-3.0
a. Central Government	0.0	-4.0	-4.3	-5.0	-4.9	-5.7	-5.5	-5.4	-5.4	-5.0
b. Social Security	2.3	2.5	2.4	2.8	2.5	2.7	2.8	2.9	2.9	2.7
c. Local Government	-0.4	-2.2	-1.6	-1.8	-1.7	-1.4	-1.3	-1.3	-1.0	-0.7
5. Total Balance (3+4)	1.8	-0.8	0.5	1.2	0.8	-1.5	-0.6	0.4	0.4	2.3
6. Current Account	1.2	0.1	0.9	1.9	1.3	-1.3	-0.5	0.7	1.0	2.2

Source: Economic Planning Agency, Annual Report on National Accounts, 1985

U.S. fiscal policy, where the government balance fell from 0.6 percent to minus 3.4 percent of GNP between 1979 and 1984.

Because the sum of the government deficit and domestic investment are not enough to absorb domestic savings, the Japanese invest a portion of their savings abroad. This foreign investment must be matched by a corresponding current account surplus.

Although household savings in Japan have fallen steadily since 1975, the level is still high compared to other countries. In 1983, household savings' share of GNP in Japan was 3.5 times higher than personal savings' share in the United States. One could say that the current account imbalances in the two countries are a result of a high savings rate in Japan and a low savings rate in the United States. But it should be noted that the low U.S. savings rate, combined with responsible fiscal policy, is not incompatible with a balanced current account. Given the historical constancy of personal savings rates, however, it is unlikely that U.S. savings and investment could be balanced by increasing personal savings. An easier approach would be to reduce the government deficit to past levels.

Possible Solutions

The large increase in the global U.S. trade deficit resulting from the savings-investment imbalance has, of course, affected this country's trade balance with Japan, its second-largest trading partner. A number of solutions, both good and bad, have been proposed to narrow the large bilateral trade deficit. Even without a change in policies, however, the problem should eventually disappear. At some point, foreign investors will refuse to put a larger share of their portfolios in dollar securities because the risk of an unbalanced portfolio will outweigh the advantage of higher returns. Once demand for dollar assets declines, the value of the dollar will fall and the trade balance will improve.

Still, there are several risks to a do-nothing approach. First, continued large trade deficits will intensify demands for import restrictions. Protectionist measures by the United States would likely lead to retaliation by other countries and have a negative effect on world economic growth. Second, the U.S. external debt will continue to grow while waiting for a correction in the dollar's exchange rate.

After three years of large current account deficits, the United States lost its position in 1984 as the world's largest creditor and became a net debtor nation for the first time since 1914. It is unprecedented for the world's largest economy to also be the largest debtor, and this situation may have profound political as well as economic effects. It is clear that the decline in net investment income resulting from the dissipation of its net asset position has exacerbated the U.S. current account deficit. In 1981, net investment income of $34 billion more than offset the $28 billion merchandise trade deficit. Dr. C. Fred Bergsten, Director of the Institute for International Economics, recently estimated that if the dollar remains at current levels, the U.S. net external debt will exceed $1 trillion by 1989. The United States would have to run a merchandise trade surplus of about $100 billion each year to finance interest payments on a net external debt of that magnitude.

Protectionism as a Solution - Political pressures are likely to force actions intended to reduce the trade deficit. Protectionism is probably the most counterproductive of the possible reactions to the deficit. A bill to levy a 25 percent tariff on imports from Japan, South Korea, Taiwan and Brazil was recently introduced in Congress. Although this measure is intended as a tax on foreigners, it will ultimately harm the U.S. economy. An import surcharge that reduces imports would raise the value of the dollar. As the dollar appreciates, exports will decline while imports regain some lost ground. The net effect is to lower the total volume of trade without much impact on the trade balance. In addition, the higher prices of imported goods would penalize consumers, and this inflationary impact would probably lead the Federal Reserve Board to tighten monetary policy, slowing economic growth.

Past experience with protectionism shows that industries that receive relief from imports are slow to adjust to foreign competition and are less competitive after protection is withdrawn. The temporary benefit to industries that compete with imports comes at the expense of sectors that depend on exports, which are the most productive and competitive industries in the economy.

An import surcharge would also lead to strains between this country and its trading partners, and would probably end the prospects for a new round of multilateral trade talks in the next few years. The debt problems of developing countries, which depend on exports to service their foreign debts, would be aggravated. Moreover, other countries would likely retaliate against the United States, reducing world trade and economic growth.

Restrictions on Capital Movements - Direct taxes and "administrative guidance" could be used to limit capital outflows from Japan or flows into the United States. Such policies, however, would be difficult to enforce given the size and sophistication of international capital markets. Moreover, they would be contrary to U.S. efforts to promote the liberalization of Japanese capital markets. It is also clear that as long as the deficit remains high, reductions in capital inflows would damage the U.S. economy. In running a budget deficit, the United States has chosen to consume more than it produces. Without an increase in capital inflows and the accompanying trade deficit, the budget deficit would crowd out domestic investment and interest-sensitive consumer purchases. In other words, capital inflows allow the excess demand generated by the budget deficit to be satisfied overseas. Given the large budget deficit, restrictions on capital inflows would raise U.S. interest rates and slow economic growth.

Monetary Policy - Altering the yen-dollar exchange rate through monetary policy has also been proposed. If monetary policy were more restrictive in Tokyo and less restrictive in Washington, the value of the dollar would decline. This option, however, ignores the domestic policy goals of central banks. Monetary policy in Japan has been relatively tight during the past several years. The discount rate has been pegged at 5 percent since the fall of 1983 and annual money supply growth (M_2+CDs) has averaged 7.7 percent since 1982. Given the expectations that inflation will continue in the 2 to 3 percent range, nominal short-term interest rates of about 6 percent imply real interest rates of 3 to 4 percent. The historically high level of real interest rates has led to frequent calls by the Japanese business community for a more

accommodative policy to accelerate the pace of economic activity. Tokyo has maintained a tight monetary policy, however, to prevent a decline in the value of the yen.

Monetary policy in the United States, on the other hand, has been very expansionary during the past year, leading to concern about future inflation. The money supply (M1) has expanded at a high 14.5 percent annual rate during the past three months and is running $13.3 billion above target for this year. New surges in money supply growth will fuel inflationary expectations, leading to high interest rates and slower growth.

Exchange Market Intervention - Coordinated government intervention in exchange markets has also been proposed to correct the existing misalignment of currencies. Policies of "leaning with the wind" might convince the market of government's commitment to lower the value of the dollar and further the move to an underlying equilibrium. There is little evidence, however, that intervention can alter the value of the dollar for more than a very brief period of time. In the past, when capital flows were smaller, it was easier for governments to influence exchange rates. With the internationalization of capital markets during the past decade, however, flows of capital dwarf the official exchange reserves available for government intervention.

Expansion of Domestic Demand in Japan - An expansion of domestic demand in Japan through fiscal stimulus has been suggested by many observers, including some members of the ruling Liberal Democratic Party. A combination of increased government spending and lower taxes would increase the budget deficit and absorb more of Japan's excess domestic savings. Prime Minister Yasuhiro Nakasone, however, appears determined to maintain his government's policy of fiscal austerity. Guidelines adopted by the cabinet project only a 1.5 percent increase in government expenditures in FY 1986. A 1979 proposal by then prime minister Masayoshi Ohira for a tax increase to reduce the deficit resulted in an electoral setback for the LDP that has made subsequent governments sensitive to the public's antipathy to tax increases and led to the present policy to slow government spending instead.

Moreover, the Ministry of Finance remains committed to reducing the large government debt. Japan's ratio of long-term debt to GNP is 48 percent compared with 34 percent in the United States. Interest payments on the debt as a percentage of government expenditures are 19 percent in Japan and about 13 percent in the United States.

Given the relatively large public debt, supply-side measures to increase domestic demand are probably a more appropriate method of reflating Japan's economy. As shown in Table 2, private investment's share of GNP fell 3 percentage points from FY 1979 to FY 1983. Lower marginal tax rates on new investment would increase investment and utilize the large pool of savings. Deregulation and administrative reform would also encourage investment, whether by domestic companies or by foreign firms in Japan. A special advisory council has called on the government to make sweeping administrative changes to revitalize the Japanese economy. Its report suggested an easing of 254 regulations in ten fields. Some have suggested higher taxes on savings to encourage consumption and reduce savings. Tokyo is reluctant, however, to discourage savings given the country's rapidly aging population.

Market Opening Measures - In July, a new market access program that is intended to reduce trade frictions between the United States and Japan was issued by Tokyo, reducing or eliminating tariffs on 1,850 items, stipulating simpler testing and certification procedures, and extending the government procurement code to an additional 16 semi-public organizations. The further opening of the Japanese market is certainly a positive development that will benefit both countries. Lower import barriers increase efficiency by allocating resources to their most productive uses.

The more immediate issue, however, is whether this will reduce the political problems caused by the trade imbalance. According to Dr. Martin Feldstein, former chairman of the Council of Economic Advisers, the current U.S. criticism of Japan is not a result of the size of the trade deficit. He noted that the U.S. bilateral trade position has actually deteriorated less with Japan since 1980 than with either the European Community or Latin America. Instead, Feldstein said, "the true basis of this frustration is the sense that Japan as a government and as a people is being unfair in its pursuit of policies that preclude foreign products from Japanese markets." Tokyo apparently intends to alter this perception through its market opening package.

At this point, however, it appears that only a change in the trade balance will alter the perception of the fairness of Japanese trading practices. Even the White House said it would withhold judgment on the market opening plan "until the effect of the program on our exports is realized." While the result should eventually be an increase in U.S. exports, it will probably be too small and too late to defuse the current dispute. On their recent trip to Tokyo, members of the trade subcommittee of the House Ways and Means Committee urged Mr. Nakasone to cut Japan's trade surplus from an expected $50 billion this year to $15 billion during the next five years. Administration officials, however, predicted in early 1985 that removal of Japan's tariff and nontariff barriers would only increase U.S. exports by about $10 billion annually, and others estimate only a $5 billion increase. It appears, therefore, that market opening measures alone, while desirable, cannot reduce the surplus to a politically acceptable level.

Reduction of the U.S. Budget Deficit - The most important and obvious solution to the trade imbalance problem is lowering the U.S. budget deficit. A reduction of the federal deficit from 4.8 percent to 2.4 percent of GNP would eliminate the savings-investment imbalance. Deficit reduction, however, requires difficult decisions by political leaders on taxes and spending issues. The $55 billion reduction package agreed to in August represents a very modest beginning in reducing the deficit. Apparently, U.S. political leaders find it easier to criticize Japan than to take the difficult steps necessary to reduce the U.S. budget and trade deficit.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

Appendix

On the product side, gross national product equals the sum of consumption, investment, government spending and net exports of goods and services: (GNP=C+I+G+X-M). On the factor income side, GNP is defined as the sum of consumption, private savings, taxes and transfer payments to foreigners by private citizens: (GNP=C+S+T+R). Combining these two definitions yields the result that the current account is equal to private savings plus the government surplus minus private investment: (X-M-R)=S+(T-G)-I.